Equities in Focus

Walt Czaicki, CFA, Senior Investment Strategist—Equities
Contributors: Bryan Chang, Investment Strategist—Equities; Ashna Jain, Product Analyst—Equities

Higher Rates, Higher Hurdles

Until recently, investors could seemingly look past higher rates as strong earnings and the AI boom propelled stocks higher. But when the cost of capital rises, eventually the hurdle for future returns rises with it.

Key Takeaways

1. **Higher Rates Matter…Eventually**
   Strong earnings initially offset higher-rate pressure, but valuations are becoming harder to ignore.
2. **Magnitude Matters**
   P/E compression becomes consistent when 10-year Treasury yields rise over 150 basis points (bps) in 12 months.
3. **Strong Fundamentals Are Taking Center Stage**
   AI's reset and the rate environment bolster the case for cash flow, profitability and capital discipline.

Rates Can Brake Check Valuations

For much of the recent cycle, investors were forgiven for thinking that higher interest rates simply didn't matter for some stocks. *Display 1* shows that when the 10-year Treasury yield moves above 4.50%, P/E multiples tend to contract. However, many AI capex–related beneficiaries bucked this historical trend as extraordinary earnings growth and enthusiasm surrounding the AI capital-spending boom overwhelmed traditional valuation and crowded-trade concerns.

But magnitude eventually matters. *Display 2* reveals that when the 10-year Treasury rises less than 100 bps over 12 months, the median change in forward P/E is actually positive. Once the increase exceeds 150 bps, however, the median P/E declines 2.2 points, with multiples contracting in 89% of observations.

The AI Trade Takes a Turn

Making things even more interesting, Treasury yields have recently fallen in a flight-to-quality trade as many AI capex–related equities have come under pressure. Investors are increasingly scrutinizing how the enormous infrastructure build-out will be financed and whether eventual revenues can justify the capital committed. So, what should investors do?

Rather than trying to predict every move in Treasury yields or the course of the AI trade, investors should focus on what they can control: the valuations they pay and the quality of the businesses they own. Companies with high cash-flow yields, strong returns on equity and steady dividend growth have been more resilient alongside elevated rates than high-beta exposures (*Display 3*).

Our View

In a higher-rate environment, investors should favor companies with durable cash flows, high returns on equity and the ability to grow dividends, rather than rely on expanding valuations. As the AI trade matures, leadership may shift from the companies enabling the build-out to those generating attractive returns on their investments and using AI most effectively. Stay invested, but raise the bar.

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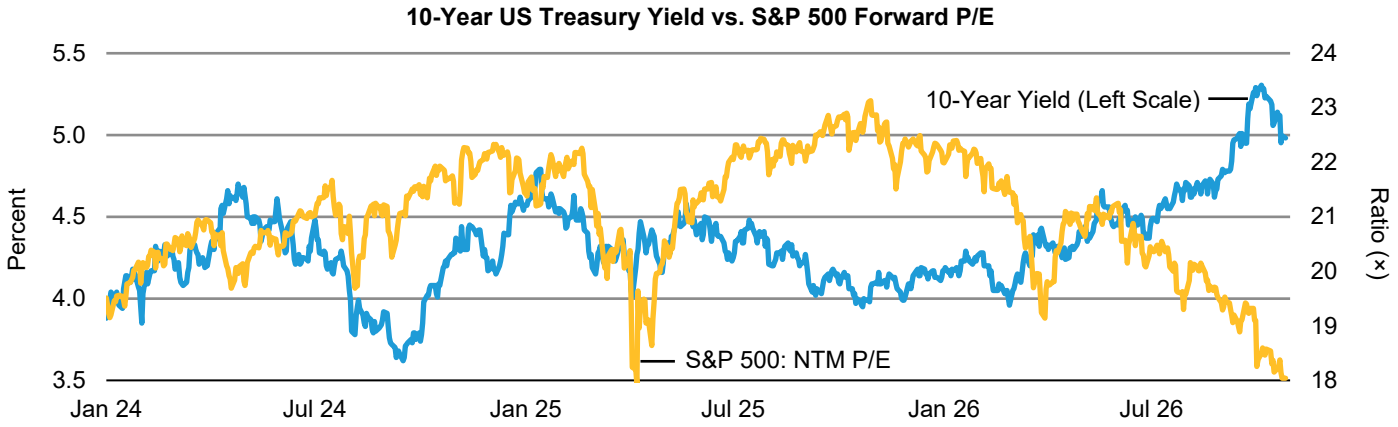
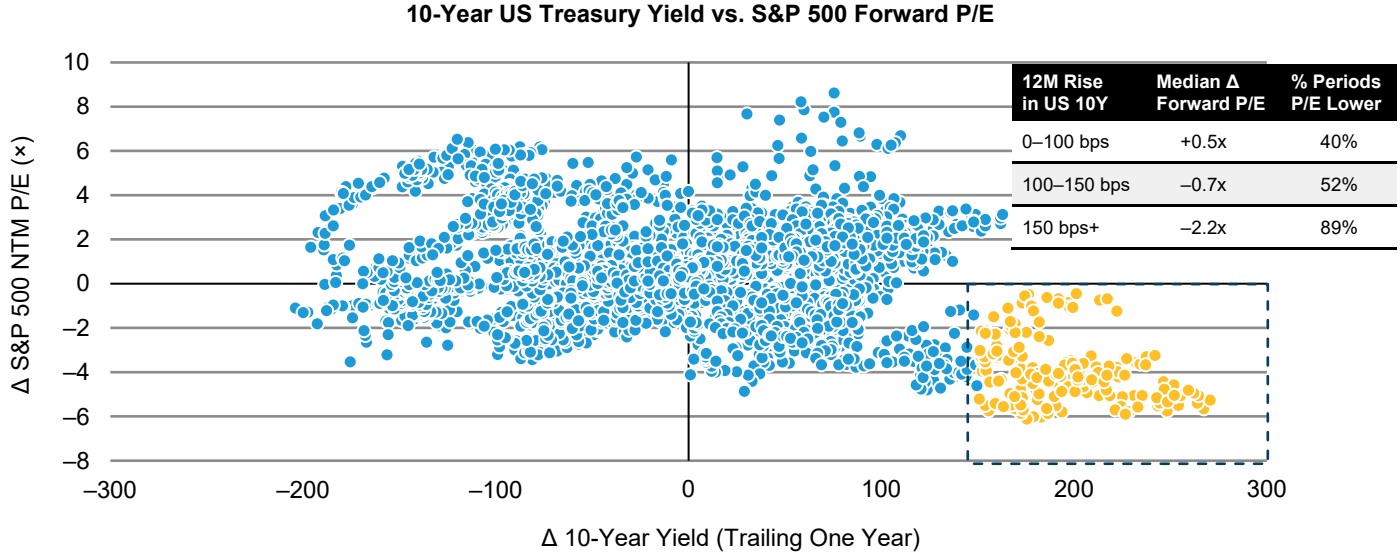
Display 1: Both Strong Earnings and Recently Higher Treasury Yields Have Driven P/Es Lower This Year…



Past performance does not guarantee future results.
NTM: next 12 months; P/E: price to earnings
As of October 26, 2026
Source: FactSet, S&P and AB

Display 2: …but Larger Yield Moves Historically Lead to Greater P/E Compression



12M Rise in US 10Y	Median Δ Forward P/E	% Periods P/E Lower
0–100 bps	+0.5x	40%
100–150 bps	–0.7x	52%
150 bps+	–2.2x	89%

Past performance does not guarantee future results.
NTM: next 12 months; P/E: price to earnings
As of September 30, 2026
Source: Bloomberg, FactSet, S&P and AB

Display 3: Value and Quality Attributes Have Been More Resilient to Elevated Rates vs. High Beta
Five-Year Factor Correlations to 10-Year and Two-Year US Treasury Yields vs. the Russell 1000 Index

	US 10-Year	US Two-Year
Cash-Flow Yield	0.63	0.69
Return on Equity	0.53	0.59
Dividend Growth	0.41	0.47
Beta	–0.36	–0.37

Past performance does not guarantee future results.
As of September 30, 2026. Source: Piper Sandler and AB

The value of an investment can go down as well as up, and investors may not get back the full amount they invested. Capital is at risk. Past performance does not guarantee future results.

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